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In the Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

v.

GEORGE W. DAVIS and
CATHERINE V. DAVIS,
Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF FOR DUPREE MUTUAL FUNDS AS *AMICUS CURIAE* SUPPORTING PETITIONERS

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

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BRIEF OF *AMICUS CURIAE* DUPREE MUTUAL FUNDS

IDENTITY AND INTEREST OF *AMICUS CURIAE*

Dupree Mutual Funds ("Dupree") respectfully submits its brief as *amicus curiae* in support of Petitioners Department of Revenue of the Commonwealth of Kentucky and Finance and Administration Cabinet of the Commonwealth of Kentucky, pursuant to Supreme Court Rule 37.3.[1] Dupree is organized as a business trust under the laws of the Commonwealth of Kentucky and is registered as an investment company under the Investment Company Act of 1940. Dupree is a no-load mutual fund based in Lexington, Kentucky that offers shares in separate investment series to the public.

Dupree operates eight single-state open-end municipal bond funds in Kentucky, Tennessee, Alabama, Mississippi, and North Carolina: the Kentucky Tax-Free Income Series; Kentucky Tax-Free Short-to-Medium Series; Tennessee Tax-Free Income Series; Tennessee Tax-Free Short-to-Medium Series; Alabama Tax-Free Income Series; Mississippi Tax-Free Income Series; North Carolina Tax-Free Income Series; and the North Carolina Tax-Free Short-to-Medium Series. Dupree's flagship fund, the Kentucky Tax-Free Income Series, is the largest single-state municipal bond fund in the Commonwealth of Kentucky, has been in existence since 1979, and currently has net assets in excess of $700 million.

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[1] Pursuant to 37.6, Dupree affirms that no counsel for any party authored this brief in whole or in part and that no person or entity, other than Dupree, made any monetary contribution to the preparation or submission of this brief. This brief is filed by Dupree pursuant to the consent of all parties.

Dupree's single-state funds are marketed primarily to residents of their respective states in order for investors to obtain the advantage of tax exemptions in their home states comparable to Kentucky's tax exemption for interest earned on municipal bonds issued within the Commonwealth of Kentucky. Dupree is one of the largest purchasers of municipal bonds issued in the Commonwealth of Kentucky. Dupree purchases bonds issued by municipalities, counties, local school boards, and similar entities, and it holds those bonds on behalf of its shareholders. Currently, Dupree has approximately 10,500 shareholders, of which approximately 7,000 are Kentucky residents.

SUMMARY OF ARGUMENT

Kentucky's tax exemption of interest earned on municipal bonds does not violate the dormant Commerce Clause. Kentucky's tax legislation supports its legitimate government purpose and sovereign interest in financing public projects for the benefit of its citizens. Kentucky passed its tax exemption regulations in order to encourage its citizens to invest in their State rather than subsidize the public works of other states. Without the exemption, the borrowing costs of Kentucky and its municipalities would increase substantially, impacting the State's ability to finance public projects. Any ruling that Kentucky's tax-exemption regulations in this context are unconstitutional would result in unprecedented judicial interference with its state sovereignty.

Furthermore, the Commerce Clause was never intended to encompass purely governmental activity. The Court's Commerce Clause jurisprudence consistently has reflected that the dormant Commerce Clause prohibits State interference with the free private market. A State may not use its treasury to advance the economic competitiveness of its in-state,

private industries to the detriment of out-of-state interests. Kentucky's tax exemption for interest earned on municipal bonds, however, does not involve any private market. Municipal bonds by definition are entirely creatures of State governments and their political subdivisions. The only "competition" is from other States' municipal bonds. The market at issue, therefore, is purely public and does not involve free private trade. The Commerce Clause does not extend to purely public activity.

Finally, Kentucky fits squarely within the "market participant" doctrine, which renders the Commerce Clause inapplicable to its activities. The market at issue is the issuance and promotion of municipal bonds. This market would not exist but for the State's involvement. By definition, private industry does not issue or compete in the issuance of municipal bonds. As no inherent profit motive exists with the financing of public works, private industry never would seek capital for the construction of public projects and does not meet the need which the State and its subdivisions fulfill. As Kentucky is a market participant in the issuance of municipal bonds, it may promote its bonds and create incentives for their purchase through tax exemptions.

ARGUMENT

I. Kentucky's Tax Exemption Supports the State's Sovereign Interest in Financing Its Public Works.

Under this Court's jurisprudence, state legislation that discriminates against interstate commerce may be constitutionally permissible if it is unrelated to economic protectionism and advances a legitimate government purpose. *See United Haulers Assoc., Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786, 1795-96

(2007); *Maine v. Taylor*, 477 U.S. 131, (1986). If the statute serves a legitimate local interest and its purpose "cannot be served as well by available nondiscriminatory means," then the statute is not violative of the dormant Commerce Clause. *Taylor*, 477 U.S. at 140. Moreover, where the legislation actually favors state and local government itself, in contrast to promoting private economic interests, the Court's precedent indicates that a lesser showing than other "available nondiscriminatory means" is required.

In *United Haulers*, the Court held that the rigorous scrutiny of laws which fostered economic protectionism was not appropriate for laws favoring local government. 127 S. Ct. at 1795-96. As the Court noted, States and municipalities are not private businesses. *Id.* at 1795. "Unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and welfare of its citizens." *Id.* (citing *Metropolitan Life Ins. Co. of Massachusetts*, 471 U.S. 724, 756 (1985) ("The States traditionally have had great latitude under their police powers to legislate as to the protection of lives, limbs, health, comfort, and quiet of all persons.")). State and local governments thus enact laws to implement innumerable legitimate goals unrelated to economic protectionism. *Id.* at 1796. When the State or local government regulation at issue furthers a typical or traditional governmental function, the courts should be particularly hesitant to interfere with the regulation under the auspices of the Commerce Clause. *Id.* Judicial scrutiny of laws promoting state and local government interests, as the dormant Commerce Clause permits in the area of private market competition, would result in unlimited judicial interference with the States and their ability to perform their traditional functions. *Id.*

In *Bonaparte v. Tax Court*, this Court affirmed more than a century ago the right of a State to tax its citizens for interest earned on municipal bonds issued by another State. 104 U.S. 592 (1881). The case arose when a resident of Baltimore, Maryland claimed an exemption for interest earned on various extraterritorial state and municipal "stocks" on the basis that they were of "public character" and exempt from taxation by the laws of their issuing states. *Id.* at 592. The Maryland tax authority denied her claim for exemption, and she sued to challenge the decision on the theory Maryland's law violated the Full Faith and Credit Clause of the United States Constitution. *Id.*

The *Bonaparte* Court upheld Maryland's authority to tax income earned on other States' municipal bonds, holding that every State has the sovereign right to tax its citizens for interest earned on extraterritorial municipal bonds, or provide an exemption, as the State deems proper. *Id.* at 595. A State may tax its citizens for income earned, regardless of the *situs* of the property or debt giving rise to the income. *Id.* The Court recognized that, even though a citizen of a state may invest in bonds issued by other States, the citizen is still "a resident of the State in which he dwells" and subject to its sovereignty. *Id.* The State has the right to see that each citizen "contribute[s] his just share towards supporting the government whose protection he claims and to whose control he has submitted himself." *Id.* Although the challenge presented to the tax law in *Bonaparte* was based on the Full Faith and Credit Clause, the case is pertinent for its recognition of the States' sovereign right to tax their citizens.

Therefore, if legislation has a rational basis to a legitimate government interest unrelated to economic protectionism, the Court should subject it to mild scrutiny and defer to the State's sovereign interests in effectuating its public purposes

and performing its traditional functions. *See, e.g., United Haulers*, 127 S. Ct. at 1795-96. In the case *sub judice*, Kentucky is not utilizing its tax-exemption provisions in order to shield its in-state industries from out-of-state competition. Instead, Kentucky's purpose is to encourage investment directly in state and local public works, which directly promotes the welfare of its citizens.

The issuance of municipal bonds allows state and local governments to borrow money to finance public projects, such as the construction of schools, bridges, sewage treatment facilities, and highways. Exemption from state taxation for interest earned on in-state municipal bonds provides an incentive for the citizens of the issuing State to invest in the public projects that benefit all citizens within the State. State and local governments realize capital cost reductions through the tax exemption, making municipal bonds an effective means of financing capital projects. *See* Dwight Denison, *et al.*, *Davis v. Department of Revenue of Kentucky: A Preliminary Impact Assessment*, Institute for Federalism & Intergovernmental Relations, IFIR Working Paper No. 2007-03, p.2, *available at* http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2007-03.pdf. "The double exemption (from both federal and state income taxes) has enhanced the marketability of muni issues and has acted as a capital subsidy for state and local government entities." *Id.*

If Kentucky no longer could provide the tax exemption, its ability to raise capital to finance its public projects would be seriously impaired as the marketability of bonds of issuers such as small school districts, cities and counties will be greatly diminshed. The State's borrowing costs would increase substantially because it would have to offer a higher return on its bonds, costing the State dollars it otherwise could have allocated to finance capital projects. *See* Linda M.

Beale, *Point & Counter Point: The Constitutionality of Tax Exemptions for Home State Bonds Under the Dormant Commerce Clause*, Wayne State University Law School Legal Studies Research Paper Series, No. 07-12, p.13, *available at* http://www.ssrn.com/link/Wayne-State-U-LEG.html. Otherwise, if Kentucky did not increase the returns on its municipal bonds, its citizens might begin investing in other States' bonds offering higher interest rates and/or backed by higher credit ratings. *Id.*

Even though Kentucky's statutory scheme should be subject only to mild scrutiny, it also passes scrutiny under the stricter standard of no other "available nondiscriminatory means." The abilities of state and local governments otherwise "to incur debt or to finance facilities out of tax revenues" has limits. *C&A Carbone, Inc. v. Town of Clarkstown, New York*, 511 U.S. 383, 428-29 (1994) (Souter, J., dissenting). The State cannot give itself a direct subsidy to finance its public projects, which presumably would have been constitutionally permissible if possible. *See, e.g., West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 198 (1994) ("A pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce . . . ."). The only practicable way for Kentucky to make investment in its municipal bonds more attractive is to provide a tax exemption for interest earned on the bonds.

Regardless of whether Kentucky could finance its public works through other means, Kentucky has the right to encourage its citizens to invest in projects that benefit the state in which they dwell. It should be able to provide incentives for its residents to invest in bonds that finance projects in their own state. Without the tax exemption, residents of Kentucky might be encouraged to divert more of their investment money to municipal bonds issued out-of-state, thereby

subsidizing the public projects of other States. Nothing in the Court's dormant Commerce Clause jurisprudence requires Kentucky to subsidize the public works of other States. If the Court were to interpret the Commerce Clause in this manner now, the result would constitute an unprecedented interference with the State's relations with its citizens as their sovereign.

II. Kentucky's Tax Exemption Does Not Violate the Commerce Clause Because the Competition in the Municipal Bond Market Is Between Co-Equal States and Free Private Trade Is Not Involved.

The Commerce Clause was enacted in part to ensure that the States did not unduly burden interstate competition between private individuals and industries by favoring their in-state, private producers and businesses. As Justice Jackson wrote, "Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them." *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 539, 69 S. Ct. 657, 665 (1949). In this vein, the Court in its early Commerce Clause decisions struck down State regulations attempting to restrict the flow of natural resources across state lines, on the basis that States are "without power to prevent privately owned articles of trade from being shipped and sold in interstate commerce on the ground that they are required to satisfy local demands or because they are needed by the people of the State." *Foster-Fountain Packing Co. v. Haydel*, 278 U.S. 1, 10 (1928).

As the Court's jurisprudence developed, the dormant Commerce Clause came to represent the principle that economic protectionism of local production to the detriment

of "the products of another state or the labor of its residents" is contrary to the national framework. *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527, 55 S. Ct. 497, 502 (1935) (Cardozo, J.). Thus, the Court's development and application of dormant Commerce Clause doctrine consistently has been concerned with preventing the States from shielding their in-state private industries from out-of-state competition. *See, e.g., West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 114 S. Ct. 2205, (1994); *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 273-74, 108 S. Ct. 1803, 1807 (1988) (States may not "benefit in-state economic interests by burdening out-of-state competitors."); *Philadelphia v. New Jersey*, 437 U.S. 617, 624, 98 S. Ct. 2531, 2535 (1978); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 269 (1984) (tax exemption for "local industries" producing traditional Hawaiian alcoholic beverages held unconstitutional).

Thus, the dormant Commerce Clause's reach extends only to "state taxes and regulatory measures impeding *free private trade* in the national marketplace." *Reeves, Inc. v. Stake*, 447 U.S. 429, 436-37, 100 S. Ct. 2271, 2277 (1980) (emphasis added). "No State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.'" *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)). As States have the potential to exert great influence on markets through their treasuries, the dormant Commerce Clause acts as a check on the States' power to impede the "free flow of private trade in interstate commerce, or . . . to discriminate against such commerce." *White v. Massachusetts Council of Construction Employers, Inc.*, 460 U.S. 204, 221 (1983). Therefore, the scope of the dormant Commerce Clause is to remove any state-imposed barriers to

"free private trade" among the citizens of the several States. The Commerce Clause, however, does not prohibit legislation advancing State creation of a public market or competition therein.

In *Hughes v. Alexandria Scrap Corp.*, this Court held that Maryland's statutory scheme for ridding the state of old automobile hulks by paying bounties to Maryland scrap processors if they presented an "indemnity agreement" from unlicensed hulk suppliers was constitutional, even though out-of-state processors were required to show more extensive documentation. 426 U.S. 794 (1976). Even though Maryland's statutory scheme created an incentive for unlicensed hulk suppliers to use in-state scrap processors, the Court concluded that no trade barrier of the type prohibited by the Commerce Clause impeded the hulks from leaving the state. *Id.* at 809-10. Instead, Maryland had simply enhanced the market for hulks by offering the bounty. *Id.* at 810.

In a concurring opinion, Justice Stevens noted the distinction between a State's participation in the private market and its actual creation of a market:

> It is important to differentiate between commerce which flourishes in a free market and commerce which owes its existence to a state subsidy program. Our cases finding that a state regulation constitutes an impermissible burden on interstate commerce all dealt with restrictions that adversely affected the operation of a free market. This case is unique because the commerce which Maryland has "burdened" is commerce which would not exist if Maryland had not

> decided to subsidize a portion of the automobile scrap-processing business.

Id. at 815.

Justice Stevens continued by recognizing that the State's failure to create commerce could not be objectionable as the Commerce Clause does not impose "any obligation to subsidize out-of-state business." *Id.* at 815-16. Similarly, the State can provide incentives or encouragement to local industry. *Id.* at 816. Under these circumstances, the State's encouragement is not objectionable as a burden on commerce regardless of whether it "takes the form of a cash subsidy, a tax credit, or a special privilege intended to attract investment capital." *Id.*

In contrast to precluding economic protectionism affecting private industry, the Commerce Clause was never intended to regulate "competition" between state governments trying to finance their public works. This Court consistently has interpreted the dormant Commerce Clause as a prohibition against state regulations that impede or discriminate against free, private markets operating in interstate commerce. The basis for the concern is the idea that States, by utilizing their more expansive treasuries *vis-à-vis* private companies or individuals, will provide an unfair competitive advantage for their own citizens at the expense of out-of-state private interests, thereby upsetting the free market.

In the present case, however, the commerce at issue does not involve private industry, or even a combination of private and public industry. Even more so than Maryland's enhancement of the market for scrap-automobile hulks, Kentucky's issuance of municipal bonds creates a market that otherwise would not exist. By definition, only the State or its

municipalities may issue municipal bonds. No private commerce is affected. Therefore, Kentucky's tax exemption does not discriminate against interstate commerce, because no private interstate trade is involved with the issuance of municipal bonds.

The competition here is narrowly limited to municipal bonds issued by other States, i.e., competition between the States' governments themselves. As Justice Stevens' concurring opinion in *Hughes* reflects, the dormant Commerce Clause serves as a check against States providing an unfair advantage to its in-state industries by using its greater treasury to the detriment of out-of-state private competition. Such a concern simply does not exist when the competition is not out-of-state private industry but other States themselves. Whether the State promotes the market it created by tax credit, subsidy, or other "special privilege intended to attract investment capital" is irrelevant. The municipal bond market in Kentucky was created by the State and would not exist otherwise. Kentucky thus chose to promote that market in the only practicable manner available to it, through legislation providing a tax exemption. Kentucky's tax exemption applies only to interest earned on municipal bonds issued by the State. Interest earned by Kentucky residents from investment in municipal bonds issued by other States is subject to regular taxation. Nothing is constitutionally impermissible about Kentucky promoting the market it created.

III. As a "Market Participant," Kentucky May Offer Tax Exemption as an Incentive to Promote Its Municipal Bonds to Its Residents.

When a State engages in "market participation," it is not subject to the restrictions placed on its regulatory authority by

the dormant Commerce Clause. *Wisconsin Dep't of Industry, Labor and Human Relations v. Gould, Inc.*, 475 U.S. 282, 289 (1986). The inquiry thus is limited to whether the challenged state program constitutes direct state participation in the market. *Reeves, Inc. v. Stake*, 447 U.S. 429, 436, n.7 (1980). When engaging in public works projects, a State or municipality acts as a market participant. *See United Building & Construction Trades Council of Camden County and Vicinity v. Mayor and Council of the City of Camden*, 465 U.S. 208 (1984). Acting as a market participant, the State enjoys the same "long recognized right of [any] trader or manufacturer, engaged in an entirely private business, freely to exercise his own independent discretion as to the parties with whom he will deal." *Reeves*, 447 U.S. at 438-39 (quoting *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919)). In other words, the State acting as market participant may favor its own citizens over out-of-state residents in the distribution of benefits resulting from the State's market activities. *Hughes v. Alexandria Scrap Corp.*, 426 U.S. [illegible] 810 (1976). Such activities are not "the kind of action with which the Commerce Clause is concerned." *Id.* at 805.

In *Reeves v. Stake*, the State of South Dakota commenced construction of a cement plant in 1919, in order to address perceived regional shortages and to ensure the State's citizens had access to sufficient quantity of the crucial building material. 447 U.S. at 430. In the years subsequent to initial construction of the facility, it produced more cement than South Dakotans required and, as a result, was selling approximately 40% of its product outside of the State by the 1970s. *Id.* at 431-32. By the time of the 1978 construction season, however, difficulties at the plant slowed production, causing the plant to be unable to fill all its orders. *Id.* at 432. Due to the shortage in production, South Dakota reaffirmed

its initial policy, which had led to the plant's construction in 1919, of allocating its supply to South Dakota customers first in preference to out-of-state buyers. *Id.* Reeves, Inc., a Wisconsin ready-mix concrete distributing company, which had been a customer of the South Dakota plant for 20 years, was forced to cut its production by 76% after the plant denied it further supply. *Id.* at 433.

In considering Reeves' Commerce Clause challenge to South Dakota's actions, the Court recognized that "[t]here is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market." *Id.* at 437. When acting as a "market participant," the State can fairly claim some measure of a sovereign interest in deciding "how, with whom, and for whose benefit to deal." *Id.* at 439, n.10. When a State engages directly in proprietary functions, the Court stated that the judiciary should exhibit some restraint as the competing considerations behind the State's activity will be difficult to assess under traditional Commerce Clause analysis. *Id.* at 439. As a seller of cement, South Dakota unquestionably met the definition of "market participant." *Id.* at 440. The Court further noted that, in undertaking the construction of the cement facility, South Dakota had filled a demand which the free market had failed to supply, without any way of knowing whether private industry ever would move into the market area to fill the State's needs for cement. *Id.* at 446. As a result, South Dakota had the right to ensure that the intended benefit of its foresight, risk and industry went to its citizens. *Id.* The Court, therefore, held that South Dakota's preferential treatment in favor of its citizens did not violate the dormant Commerce Clause.

Similarly, in *White v. Massachusetts Council of Construction Employers*, the Court upheld an executive order

issued by the mayor of Boston which required all construction projects funded, in whole or in part, by city funds to be performed by a work force comprised by at least a half of Boston residents. 460 U.S. 204 (1983). The Court noted that a state or local government is not subject to the constraints of the Commerce Clause once it has entered the market as a participant. *Id.* at 208. As a corollary, the Court further recognized that the inquiry whether any adverse impact on interstate commerce existed was pertinent only if the city was regulating the market rather than participating in it. *Id.* at 210. To the extent that the city expended its own funds to finance public projects, the Court held it was a market participant and could condition the parties with which it would deal. *Id.* at 214-15.

Moreover, as discussed above, when a State effectively creates a market which did not exist previously, it may implement legislation that impacts the competitiveness of out-of-state competition. *Hughes v. Alexandria Scrap*, 426 U.S. 794 (1976). In *Hughes*, Maryland's statutory scheme created an incentive for unlicensed automobile-hulk suppliers to use in-state scrap processors. *Id.* at 809-810. Yet, as Maryland simply had enhanced the market for the hulks by offering a bounty, the Court concluded that the State had not created a trade barrier of the type prohibited by the Commerce Clause. *Id.* at 810.

Kentucky is a participant in the municipal bond market. Its competition is other state governments. The tax exemption Kentucky provides to its residents for interest earned on state and local municipal bonds directly promotes the State's bonds. The exemption makes the State's municipal bonds more attractive to in-state investors than the bonds of other state governments. In essence, Kentucky's tax exemption scheme operates in a manner comparable to a manufacturer's

rebate or coupon. A private manufacturer may offer a cash rebate or coupon as an incentive to a consumer for purchasing the manufacturer's product. The State certainly should be able to offer analogous incentives for its products when acting as a market participant.

Furthermore, Kentucky's purpose in promoting the issuance of, and market for, municipal bonds is to raise capital financing for public projects that otherwise might be unsupportable by the limits of the public fisc. By their inherent nature, such projects do not encompass a private profit motive. Thus, private industry has no incentive to undertake the building of schools, or highways, or bridges. These projects, however, are critical to the citizens of Kentucky. As with South Dakota in *Reeves*, Kentucky has created a market that would not be filled otherwise by private industry. Therefore, Kentucky may properly favor with a tax benefit its citizens who support the State's goal of financing public works. Kentucky's promotion of municipal bonds via its tax exemption regulations is necessary to advance its legitimate marketplace goals.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

Respectfully submitted,

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